



A GFOA ***advisory*** identifies specific policies and procedures necessary to minimize a government's exposure to potential loss in connection with its financial management activities. It is *not* to be interpreted as GFOA sanctioning the underlying activity that gives rise to the exposure.

Use of Derivatives and Structured Investments by State and Local Governments for Non-Pension Fund Investment Portfolios (1994, 2002, and 2010) (TIM)

Background. A derivative product is a financial instrument created from, or the value of which depends on (is derived from), the value of one or more underlying assets or indices of asset values. Derivatives may include forwards, futures, options, swaps (currency and interest rate), caps, floors, collars and rate locks.

Structured investments are financial instruments that are created (structured) through pooling or redistributing assets, tranching liabilities (backed by pools of assets) and/or separating the credit risk of the collateral assets from the originating entity. Examples of such instruments commonly used by governmental entities may include asset backed securities, mortgage backed securities, various collateralized obligations and credit derivatives among others.

Advisory. The Government Finance Officers Association (GFOA) advises state and local government finance officers to exercise **extreme caution** in the use of derivatives and structured finance products. Governmental entities must learn about and understand the potential risks and rewards of derivative and structured products, before deciding if they should be used. Governments must understand fully the characteristics of these instruments and have the ability (internal staff and expertise) to determine the fair market price and be aware of the legal, accounting, credit and disclosure risks involved.

Governments should consider the following factors in determining whether to use derivatives and structured investment products:

1. **Legality.** Governmental entities should understand that state and local laws may not specifically address use of these products. Factors to consider include:
 - the constitutional and statutory authority of the governmental entity to execute derivative contracts or to buy structured finance products,
 - the potential for violating constitutional or statutory provisions limiting the governmental entity's authority to incur debt resulting from the transaction, and
 - the application of the governmental entity's procurement statutes specifically to derivative transactions.
2. **Appropriateness.** Governmental entities must observe the objectives of principal preservation, liquidity, and return within legally allowable investments. Judicious asset and liability management policies help achieve these objectives while managing risk. Characteristics of some derivatives and structured investment products that may preclude their use and make them inappropriate include high price volatility, illiquid markets, valuation difficulties, insufficient market history, high degree of leverage, keen monitoring and modeling system requirements, and the need for a high degree of sophistication to manage risk. Governmental entities should be aware of all the risks associated with the use of derivatives and structured investment products, including credit, counterparty, market, prepayment, liquidity, settlement, custodial and operating risk.

Regarding the difficulty in valuing derivatives and structured investment products, governmental entities should understand that there may be little or no pricing information or standardization for some derivatives and structured investment products. Competitive price comparisons are recommended before entering into a transaction. Even in cases of competitive pricing, because valuations of such products are based on highly sensitive models and not on actual markets, changes in the underlying assumptions may severely impact asset values.

In addition to determining legality and appropriateness, governmental entities should analyze the materiality of a transaction to determine if it might affect a bond or other credit-related rating of such entity. Rating agencies should be notified if required.

3. **Procedures and Internal Controls.** Governmental entities should establish internal controls for use of derivatives and structured investment products to ensure that risks involved with these are adequately managed. Such procedures should include:
 - Creating an oversight board and establishing upfront criteria for use of derivatives and/or structured securities;
 - Comprehensive derivatives and structured securities policy (evidencing legal authority, listing authorized and prohibited types of derivatives and structured investments, identifying guidelines for counterparty selection, limiting maximum permissible amounts and specifying means of determining such maximums);
 - Review with ratings agency(ies) impact of derivatives use on governmental entity;
 - Written statement of purpose and objectives for derivative use,
 - Written procedures for monitoring of derivative instruments and structured investment products, including how often they will be priced and what pricing services will be used;
 - Periodic training for managers and access to technical resources to oversee derivative and structured investments;
 - Sufficiently detailed recordkeeping to allow governing bodies, auditors, and examiners to determine if the program is functioning in accordance with established objectives. Managers should report regularly on the use of derivatives to their governing body and appropriate disclosure should be made in official statements and other disclosure documents:
 - Reporting on derivative use in accordance with generally accepted accounting principles. Because of the complexity of these instruments, governments should consult with public accountants at an early point to determine if specialized reporting may be required:
 - Required documentation of stress testing and scenario analysis of derivatives and structured investment products. Every possible effort should be made to determine worst case scenarios when using derivatives or structured products, as well as likelihood or probability of these outcomes and the government's ability to weather them; and
 - Procedures for evaluation and review on a periodic basis.

- 4. Role of External Parties.** Governmental entities should know if their broker-dealers are merely acting as intermediaries or are taking a proprietary positions in derivatives or structured investment product transactions. Possible conflicts of interest should be taken into consideration before entering into a transaction.

Governmental entities should exercise caution in the selection of broker-dealers or investment advisers. They should confirm that these vendors are knowledgeable about, understand and provide disclosure regarding the use of derivatives and structured investment products, including benefits and risks.

Governmental entities are responsible for ensuring appropriate safeguards are in place when derivative or structured investment product transactions are conducted by a third party acting on behalf of the governmental entities.

The GFOA reiterates the need for governments to exercise extreme caution when considering derivative products for their investment portfolio. It is important to emphasize that these instruments should not be used for speculation.

Governmental entities must learn about and understand the risks and rewards of derivative and structured investment products in order to properly evaluate and manage. Governmental entities should consider the use of derivatives and structured investment products **only** when they have attained a sufficient understanding of the products and the expertise to manage them. Certain derivative products and structured investment products may not be appropriate for all governmental entities.

Ultimately, it is the responsibility of each governmental entity to determine what constitutes a derivative and/or a structured investment, and what is allowable by statute and policy.

References.

- *A Public Investor's Guide to Money Market Instruments*, Second Edition, edited by M. Corinne Larson, GFOA, 1994.
- GFOA Best Practice: Use of Debt-Related Derivatives and Development of Derivatives Policy, 2010, GFOA's Committee on Governmental Debt Management.
- GFOA Derivatives Checklist, 2010, GFOA's Committee on Governmental Debt Management.

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